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Third World Debt

May 1989

Background: The ability of many Third World countries to service their external debt deteriorated sharply between 1980 and 1982. The US responded by developing a flexible, case-by-case approach stressing economic adjustment by debtors and financial support for such adjustment by the international financial community. Building on this approach, the US in 1985 outlined a program to sustain and improve growth in debtor nations (the Baker plan). In March 1989, Secretary of the Treasury Brady outlined proposals for strengthening the existing international debt strategy.

Scope of problem: By the end of 1987, the gross external debt of Third World countries totaled nearly $1.2 trillion, up from $752 billion at the end of 1982. The countries of Latin America and the Caribbean accounted for about 38% of the total debt. Brazil owed $124 billion, followed by Mexico ($108 billion), Argentina ($57 billion), and Venezuela ($37 billion). Major debtors outside Latin America included Indonesia ($53 billion), Egypt ($40 billion), Nigeria ($29 billion), the Philippines ($30 billion), and Algeria ($23 billion). Sub-Saharan African countries accounted for about 11% of the total.

Origins of the crisis: Several factors precipitated the debt crisis of the early 1980s. Of greatest importance were inappropriate domestic policies in many debtor countries. These policies resulted in overvalued exchange rates, large budget deficits, heavy investment in inefficient public enterprises, and excessive restrictions on trade and investment. External shocks, such as the 1979 oil price jump, a sharp increase in real international interest rates, and spreading recession in the developed countries, were additional factors. Also, many borrowers relied on short-term, variable-rate loans that made them particularly vulnerable to rising interest rates and sudden changes in bank lending.

Initial response: Working with other creditors in 1982, the US helped develop rescue packages to deal with the immediate liquidity problems of major debtors. These packages were made available on a case-by-case basis depending on the circumstances in each country. This approach succeeded in averting default by major debtor countries and in keeping the international financial system intact. Many debtors were able to improve their external accounts and reverse the economic decline of the early 1980s. By mid-1985, however, the view emerged that the international debt strategy needed further strengthening. Commercial lending to developing countries had declined significantly. Debtor governments were concerned that economic adjustment programs were reducing living standards for their citizens.

Program for Sustained Growth: At the IMF-World Bank annual meeting in October 1985, the US proposed the program for sustained growth. Building on the earlier response, the program outlined a broad long-term strategy to restore creditworthiness of debtor countries by promoting sustainable growth. The program had three elements. The

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first and most important was the pursuit of comprehensive, growth-oriented macroeconomic and structural reforms in the debtor countries. These reforms would permit market forces and private enterprises to play a larger role in the economy, encourage greater domestic savings and investment, reduce budget deficits, and liberalize the trade and financial systems. The second element called for $20 billion in commercial bank lending over 3 years. The third element involved the international institutions. The IMF would still play a central role in coordinating the debt strategy but would strengthen the structural reform component of its programs. The multilateral development banks would increase lending to debtor countries by 50% in 1986-88 and link new credits more closely to economic reforms. The US in April 1987 strongly encouraged the development of a "menu" of market-driven financial instruments to help meet the diverse interests of both debtor nations and the banking community in devising new financing packages.

Progress under the Program for Sustained Growth: Progress under the strengthened debt strategy included the increasing recognition within developing countries that long-term growth requires a strong commitment to market-oriented policies. In addition, US banks became less exposed to Third World debt due to greater bank capital and some reduction in outstanding debt. An impressive array of voluntary debt reduction mechanisms sprang up--including buy backs, debt equity swaps, and exit bonds. The menu approach helped facilitate new financial flows, while also providing a way to convert outstanding debt obligations into alternative instruments. The 1988 Toronto summit expanded Paris Club (official creditors) debt relief for low-income African countries' debt.

Brady proposals: Despite the progress made, the review of the debt strategy ordered by President Bush concluded that several serious problems remained:

- Debtor reforms in several countries had not been applied consistently;
- Low investment and capital flight continued to weaken future economic prospects;
- New loans from commercial banks were not always forthcoming in a timely fashion; and
- Many debtor nations had not achieved adequate growth on a sustained basis.

Speaking to the Bretton Woods-Brookings conference on March 10, 1989, Secretary Brady outlined a series of proposals to strengthen the debt strategy. The proposals have gained widespread international support. The suggested approach builds upon the principles that guided the existing strategy--the importance of stronger growth, economic policy reforms, the provision of external financial support by creditors, and the treatment of each country's needs and problems on an individual basis. Although recognizing the continued importance of new commercial bank lending, the new approach places more emphasis on voluntary debt and debt service reduction, new investment, and flight capital repatriation. The IMF and World Bank would still play a central role within the debt strategy in encouraging debtor policy reforms and catalyzing financial support.

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